Uganda
Seventh Poverty Reduction Support Credit (4431-UG)
Release of the Second Tranche – Full Compliance

Tranche Release Document

1. The Board approved the two-tranche Seventh Poverty Reduction Support Credit (PRSC 7, Cr. No. 4431-UG) of SDR 125 million on May 7, 2008 to support the Government of Uganda's third Poverty Eradication Action Plan (PEAP III).

2. Following the Board decision, the Financing Agreement for PRSC 7 was signed on June 13, 2008 by the Borrower and the International Development Association (IDA). The Credit was declared effective on December 9, 2008 with the first tranche of SDR 62.5 being released upon effectiveness.

3. PRSC 7 was the third and final budget support operation in a development policy lending series under IDA14 which included PRSC 5 and PRSC 6. This three operation series was integral to the Bank's Uganda Joint Assistance Strategy (UJAS) discussed by the Board on January 17, 2006. Unlike previous PRSCs in Uganda, which were annual single tranche operations, PRSC 7 was designed as an exceptional two tranche PRSC in order to provide time to harmonize future PRSCs under a new joint budget support framework with other donors. The second tranche was made conditional upon; (i) the Government maintaining a stable macroeconomic environment, (ii) the Government approving the FY2008/09 Budget consistent with the PEAP and its medium-term growth objectives, and (iii) the Government submitting to Cabinet draft proposed amendments to the procurement law and regulations.

4. The total amount of funding under PRSC7, at SDR 125 million represented an increase of SDR 41.7 million compared to the PRSC6 of SDR 83.3 million. However, the two tranches were designed to disburse into two different fiscal years, amounting to a reduction by SDR 20.8 million in Bank annual support under the PRSC7 in light of slower than expected implementation of policy actions.

5. The overriding themes of the broader PRSC 5-7 series were to support the Government in delivering better services and to create a better policy environment for economic growth and poverty reduction. A core focus of the program was therefore on supporting actions under the fourth pillar of the PEAP3, on "good governance". This included actions to strengthen commercial courts, public financial management, budget reporting, public procurement, public sector management and accountability, and the framework for decentralization.

I. Background

6. The PRSC5-7 series in Uganda continued to support a policy and institutional framework which has yielded solid results in terms of growth and poverty reduction. During the implementation of the government's poverty reduction strategy under the three

successive PEAPs, the number of households who live under poverty in Uganda has fallen impressively (down to 31 percent in 2005/06 from 44 percent in 1997 and from 38 percent in 2001/02). Economic growth has remained high with annual real GDP growth averaging 8.3 % over the last 5 years to 2007/08 in the face of exogenous shocks, including the global food crisis and a Ugandan energy crisis. This growth performance is all the more impressive coming several years after the initial stimulus to the economy from post-conflict rebound and one-off privatization, price and market reforms had worn off. During the 1990s growth averaged 6.5 percent annually, some 1.8 percentage points lower per year.

7. The core focus of the PRSC 5-7 series remains highly relevant, even as thinking about the PEAP in Uganda has evolved. For the last 2 years of implementation of PEAP3, Government of Uganda has begun to reorient the country's development strategy, placing higher emphasis on sustaining the continued rapid pace of economic growth that the country has enjoyed, whilst striving to accelerate structural transformation of the economy into manufacturing and services to create jobs of the world's fastest growing workforce. This reorientation is fully consistent with the Bank's advice in the 2006 Country Economic Memorandum. It is now being reflected in the annual budgets, and the evolving 5-year National Development Plan (NDP) will have the theme of "Growth, Employment and Prosperity". To sustain rapid growth and achieve export-led structural transformation, Government's main emphasis is, rightly, to seek to avoid the fast growing economy from running up against more infrastructure shortages, particularly in road transport and electricity sectors. The annual budgets for 2007/08 and 2008/09 included large increases in funding for electricity and roads projects. The reorientation of policy towards infrastructure has underscored the importance of the core focus of the PRSC7 program on supporting actions on the PEAP's "good governance" pillar. Given the high share of contracts in infrastructure sectors, reforms to the public procurement laws are now even more important to the achievement of good governance under PEAP3, and are even more important to getting value for money from Uganda's budget than previously.

8. The PRSC7's focus on institutions and reforms in public sector management and accountability also remains highly relevant to the renewed focus on infrastructure, because these issues are the key to achieving better efficiency and economy in public spending. Consistent with the 2007 Public Expenditure Review, Government recognizes that Uganda needs to find additional fiscal space to pay for what amounts to a sizeable scaling up of investments in roads and electricity, whilst maintaining ambitious targets for human development for a growing population - such as universal primary and secondary education, as well as free basic health care. The Government and the Bank have assessed that creating sufficient fiscal space for scaled up infrastructure in the medium-term without compromising improvements in other services, will require comprehensive public sector management reform and greater accountability to realize efficiency gains and to get better value for money in public spending. There is limited scope for a rapid increase in revenue mobilization in Uganda, and aid volumes could prove less reliable with the onset of the global crisis. A main focus of the Joint Budget Support Framework which succeeds PRSC7 will therefore be supporting reforms in public spending for service delivery, where the potential for getting more outputs for a given level of spending is greatest.

9. Better public sector performance and hence better efficiency in public service delivery in Uganda is impeded by entrenched governance problems in public administration and public sector management. These areas in most need of substantial reform are also areas of relative weakness in Uganda's CPIA ratings relative to other IDA countries. Uganda performs considerably better than average for IDA countries (and the Africa region) on economic management (with high macroeconomic, fiscal, budget and structural CPIA scores) but only average or even below average on service delivery, PSM, efficiency of revenue mobilization, quality of public administration, and transparency, accountability and corruption.

10. The continuation of reforms in the areas which were supported under the PRSC5-7 series therefore remains essential for successful execution of the Government's nascent strategy for growth, structural transformation and human capital development which will succeed PEAP3. Implementation progress under PRSC7 should be a strong predictor of progress under the new series.

II. Recent Economic Developments

11. The global financial crisis is slowing down the rate of growth of Uganda's economy by reducing FDI, private transfers, reducing tourism receipts and lowering the price of Uganda's exports. Growth in 2008/09, though down from the 9.5% achieved in 2007/08, was still an impressive 7%. Real growth is expected to slow to 6% in 2009/10. But Uganda entered the crisis following several years of growth with strong fundamentals and prudent policies. This strong initial position means Uganda can in the short-term afford to use counter-cyclical policies without threatening macro stability. The pro-growth fiscal policy stance already adopted pre-crisis amounts to an appropriate stimulus package for the economy.

12. Uganda's banking sector is isolated from the defaults and risks in the international system. The banking system – though small - is stable and strong, with very limited exposure to the sub-prime market or to foreign currency debt. Uganda's foreign exchange reserves at US$ 2.7 billion were equivalent to about 6 months of imports by June 2008. Fiscal policy was already geared towards addressing infrastructure constraints for growth. Consequently, Uganda was shielded against the first round crisis effects, except for the temporary instability in the foreign exchange market during October 2008 as some off-shore investors retracted their portfolio investments.

13. During 2008/09, some noticeable effects on the balance of payments were felt through reduced remittances (by about US $ 300 million), reduced export prices, and a decline in FDI to 3.3 percent of GDP (half of 6.7 percent recorded in 2007/08). Exchange rate depreciation towards the end of 2008 and into early 2009 allowed the private sector to adjust, but private investment slowed slightly. Fiscal revenues were 0.2 percentage points of GDP lower than budgeted in FY2008/09. Government responded mid-year with an offsetting trimming of public expenditure in non-essential activities. By the end of the fiscal year, slower than planned expenditure on roads because of project implementation delays

meant Government did not need to draw on their sufficient room to use domestic financing or to draw down ample reserves to maintain the 2008/09 fiscal program.

14. Inflationary pressures driven by higher food and fuel prices, persisted into 2008/09. At 14 percent by end-March 2009, inflation was almost triple the target of 5 percent. With about 5 percentage points of this on account of external shocks, it is envisaged that inflation will decline as these global food price pressures continue to subside. Following the global economic crisis, the real exchange rate depreciation during 2008/09 should allow for the necessary adjustment in the economy, as the balance of payments position worsens. And although tighter monetary policy during the early months of the crisis was followed with a rise in interest rates, this has been reversed as monetary policy hedges towards an easier stance to support growth, as the risks of rising inflation to growth subside.

III. Progress against Tranche Release Criteria

15. Overall progress in implementation of the Government of Uganda's medium-term strategy to sustain broad-based growth and reduce poverty has been satisfactory. The main issue under PEAP3 implementation – that Government needed to re-orient towards more of a growth focus - has not materially affected the relevance of the PRSC series for the reasons set out above. However, the lack of a technical framework for sequencing and prioritizing reforms under PEAP3 has been both a cause and a symptom of capacity weaknesses in policy formulation and implementation. With limited implementation capacity, Uganda should set out to do less and to focus on what needs doing most. Otherwise, Government runs the risk of not implementing what is most needed.

16. Implementation of some of the more important reforms identified under the governance pillar of PEAP3, and supported under the PRSC5-7 series, has been subject to increased political economy constraints and has been less satisfactory. With the advent of contestable multi-party politics in Uganda, populism, patronage and party funding have become increasingly more important factors in determining the feasibility of reforms than they were under past PRSC series. Meanwhile with a genuine opposition, Parliament has become more vociferous. These political factors are a natural consequence of Uganda's increased political maturity and bring new challenges. They are most seriously and directly constraining progress in the areas of public sector reform, anti-corruption, decentralization and public procurement. But they also pervade the sequence and prioritization of reforms, and the pace of implementation. This happens because in contrast to the past situation in Uganda, technocrats have less freedom than in the past to design policy making.

17. The first two second tranche conditions were chosen to limit disruption to funding in the transition to a harmonized joint budget support framework, whilst ensuring that the minimum entry criteria for budget support were met. The third condition revising the procurement law originally was agreed by Government as a prior action for Board discussion but was not met in time for the Board meeting. Given its importance, it was therefore amended and carried over into the second tranche. Bank experts were invited by the government to join a technical task force that would bring the procurement law and

regulations to acceptable standards. Government expected the revisions to be completed by September 30th, 2008. This was an indicative review date, not a deadline for the prior action to be met. No deadline was set for the prior action in the Financing Agreement for the credit which is set out in paragraph 24 below. Meanwhile Government agreed to and has fulfilled some additional undertakings including a review of 1,000 procurement cases to offset the original lapse in amending the procurement law. These are being used by the procurement agency to inform the development of actionable indicators of compliance with procurement procedures. These indicators have been proposed to Government for inclusion in the joint budget support framework which will succeed PRSC7.

18. *Condition 1: Macroeconomic environment: In accordance with paragraph 13(i) of the Letter of Development Policy, the Recipient has, to the satisfaction of the Association, maintained a stable macroeconomic environment, as shall be evidenced by a joint review with the Association.*

19. The Bank staff reviewed the macroeconomic environment with Government in November 2008 and again with the IMF in April 2009. Strong and prudent macroeconomic management policies kept Uganda's economy resilient and stable in the face of exogenous shocks in 2007/08 which came in the form of floods in the East and high food and oil prices. Real GDP growth in 2007/08 remained surprisingly strong at 9.5 percent. Growth in 2008/09 slowed down slightly to 7 percent as Uganda felt the impact of the global downturn. The authorities' response to the initial effects of the international financial crisis and the subsequent global slowdown has so far been appropriate and prudent.

20. This condition is considered as met.

21. *Condition 2: FY2008/09 Budget: In accordance with paragraph 13(ii) of the Letter of Development Policy, the Recipient has approved the FY2008/09 budget consistent with the PEAP and its medium-term growth objectives.*

22. Consistent with the Government's PEAP and medium-term growth objectives as well as with Bank advice under the CEM, the 2008/09 budget continued to scale up expenditures on electricity and trunk roads (with the creation of a National Roads Agency). Also consistent with the Bank's Public Expenditure Review of 2007, this scale up was accommodated through a prudent widening of the fiscal deficit compared with the PEAP target. This amounts to a slowdown in the Government's fiscal consolidation strategy, not a change in the strategy. Government also halted in the 2008/09 Budget the recent trend of declining conditional grants for non-salary health and education spending at District level and held firm on pay increases. With new funds flowing to infrastructure sectors, the shares of the budget going to service sectors and productive infrastructure rose relative to the shares for security and public administration.

23. This condition is considered as met.

24. *Condition 3: Amendment to the Public Procurement and Disposal Act and Regulations: In accordance with paragraph 13(ii) of the Letter of Development Policy, the*

Recipient has submitted to the Cabinet the draft proposed amendments to the Public Procurement and Disposal Act and Regulations, as shall be evidenced by submission to the Association of published draft amendments.

25. Under the PRSC 6, the Public Procurement and Disposal of Asset Authority indicated the main areas of weakness in the PPDA Act. Under PRSC 7 it was initially agreed that government would prepare a draft of revisions to address these weaknesses. These were to be subject to review and comments by the World Bank and were to be approved by Cabinet by January 31, 2008. PPDA prepared the draft amendments, but the quality was not acceptable to the Bank. The Government then set up a Technical Working Committee (TWG) to take over the preparation of the Amendments. The Bank's procurement experts were members of the Technical Working Group. Given the importance of this reform, the Government proposed to include this undertaking as one of the triggers for the release of second tranche funding under PRSC7, with the revision that it would be submitted to Cabinet rather than approved by Cabinet (paragraph 45 of Report No. 43229-UG). As set out in paragraph 11.3 (iii) of the Letter of Development Policy, Government intended to submit the revised law to Cabinet and Parliament by September 2008. However, progress in agreeing upon satisfactory amendments through the TWG was further delayed. In February 2009 the Ministry of Finance submitted to Cabinet principles for the proposed amendments to the PPDA Act. These were discussed by Cabinet in June, 2009. Following that discussion some of the proposed Amendments were rejected, and others introduced which weaken certain sections of the Law. The most significant weaknesses include; the deletion of provisions that clarify the applicability of the law to the procurement and disposal of land, assigning PPDA the power to permit deviations from Competitive Procurement Methods, and the introduction of force account as a procurement method. The Bank team has notified the Government of these weaknesses, and discussions are continuing. In line with condition 3, the proposed Amendments were submitted to Cabinet in July 2009.

26. This condition is considered as met.

IV. Conclusion and Recommendation

27. In view of the overall performance and progress with the implementation of the program supported by the Credit, and in compliance with the specific conditions of release as described in paragraphs B1-3 of Schedule 1 of the Credit Agreement, the Association has informed the Borrower of the availability of the second tranche in the equivalent of SDR 62.5 million.

Annex I. Macro-Economic Indicators

Indicators	2003/04	2004/05	2005/06	2006/07	2007/08 est.	2008/09	2009/10	2010/11
						<----------Projection---------->		
	(Annual percent change)							
Domestic prices								
Average overall (Headline) Inflation	5.0	8.0	6.6	6.8	7.3	12.0	6.0	5.0
Average Underlying inflation(excl. food crops)	5.0	4.7	5.2	7.8	7.5	10.6	6.8	5.9
GDP deflator	3.2	9.8	6.7	8.2	5.0	12.7	5.9	4.9
Exchange rate								
Nominal effective exchange rate	-10.1	7.9	–	--	--	–	--	–
Real effective exchange rate	-8.5	11.1	-1.3	--	--	–	--	–
Terms of trade (deterioration -)	5.7	1.9	16.5	13.0	-7.8	-2.0	-2.4	-2.4
National income accounts								
Agriculture	1.6	2.0	0.5	0.1	1.2	-2.9	0.2	1.9
Manufacturing	6.3	9.5	7.3	5.6	7.3	6.2	2.5	2.5
Services	7.9	6.2	12.2	8.9	10.8	-2.8	6.8	7.1
Total GDP at market prices	6.8	6.3	10.8	8.6	9.5	7.0	6.0	6.0
GDP per capita	3.5	3.0	7.5	5.3	6.2	3.7	2.7	2.7
	(As percentage of GDP at market prices)							
Real Sector								
Gross domestic investment	21.3	22.5	24.4	25.6	27.3	26.9	28.9	29.8
Public Investment	5.1	4.9	5.2	5.5	6.2	9.6	10.5	11.1
Private Investment	15.9	17.4	19.1	19.9	21.0	17.2	18.2	18.6
Gross national savings(i.e. excl grants)	11.8	12.9	13.2	14.8	14.5	15.5	15.4	17.0
Public	-4.3	-3.0	-0.7	-0.7	0.7	1.0	2.9	3.0
Private	16.1	16.0	13.9	15.5	13.8	14.5	12.5	14.0
External Sector								
Current account balance(including grants)	0.1	-1.4	-3.3	-2.7	-6.1	-7.9	-9.4	-9.0
Current account balance(excluding grants)	-8.3	-9.5	-8.0	-7.3	-9.1	-12.5	-13.8	-13.4
Exports of goods & nonfactor services	12.5	13.1	15.3	16.6	19.8	15.7	14.5	14.0
Imports of goods & nonfactor services	-22.1	-23.9	-26.6	-27.8	-32.3	-31.0	-30.9	-30.2
Trade balance	-8.5	-9.1	-9.3	-8.4	-8.8	-12.1	-12.9	-12.7
External Debt to GDP ratio	68.4	56.5	53.9	18.5	20.0	22.1	23.8	24.4
o/w Public &Publically guaranteed	58.1	47.9	45.7	11.4	12.3	13.9	15.6	17.1
Debt-service to exports ratio	32.0	25.4	18.7	12.0	7.7	8.3	10.2	12.2
Public debt service to exports ratio	16.6	14.2	8.9	4.1	2.1	2.3	2.8	3.3
Foreign reserves (in months of imports)	-6.2	-6.0	-5.1	-5.3	-6.4	-6.1	-6.1	-5.8
Government Finance								
Domestic Revenue	10.9	12.2	12.5	12.6	13.0	12.4	12.9	13.4
Total expenditure and net lending	20.1	20.2	17.8	18.2	17.8	21.3	20.6	21.7
Overall deficit (excluding grants)	-9.2	-8.0	-5.3	-5.6	-4.8	-8.9	-7.7	-8.3
Overall deficit (including grants)	-1.4	-0.5	0.1	-1.1	-2.1	-4.4	-4.5	-4.5
Domestic borrowing	-1.3	-0.5	-1.1	-1.0	-0.3	1.5	0.7	0.6
Net Foreign financing	2.0	0.8	0.6	1.8	2.5	3.0	3.7	3.7
Sectoral Expenditure (percent of total expenditures) (includes donor financing)								
Roads and Works	8.3	11.9	10.1	11.3	13.2	18.5	17.4	16.5
Agriculture	3.5	3.6	4.0	3.8	4.3	3.8	4.4	4.6
Education	18.8	18.8	17.1	17.6	16.1	15.4	16.2	14.9
Health	12.2	10.8	13.7	9.3	9.0	10.7	10.2	10.8
Security	10.8	11.0	10.1	9.2	9.3	8.1	7.6	7.9
Water	3.0	3.2	3.0	3.0	3.3	2.6	2.2	1.9
Law and Order	6.5	5.6	4.9	5.0	4.9	4.8	4.8	4.6
Accountability	7.9	6.1	4.7	4.8	4.9			
Economic Functions and Social Services	8.7	9.2	10.9	16.4	15.9			
Public Sector Management	5.0	5.3	6.0	5.7	6.0			
Public Administration	7.3	8.2	7.6	7.3	7.2			
Interest payments	7.9	6.5	7.8	6.2	6.1	6.5	6.0	5.3

Source: Ugandan Authorities and Staff Estimates